CA. Adithya Kiran. FCA, CFA (USA)
Mobile: 8885814554. E-mail: eluruadithyakiran@yahoo.com

# CHAPTER-9: AUDIT OF FINANCIAL STATEMENTS – PART-I

## SECTION-I: ASSERTIONS

*In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income and expenses in accordance with the applicable financial reporting standards.*

| Assertions about transactions and events for the period under audit *(Income Statement Assertions)* | Assertions about account balances at the period end *(Balance Sheet Assertions)* | Assertions about presentation and disclosure |
|---|---|---|
| 1. Transactions and events that have been recorded have ***occurred***. | 1. All assets, liabilities and equity that have been recorded exist. | 1. Events, transactions and other matters that have been recorded have occurred (***Occurrence***). |
| 2. Transactions and events recorded pertains to the entity. | 2. The entity controls all the assets that have been recorded and all liabilities and equity that have been recorded represent the obligations of the entity***(Rights and Obligations)***. | 2. Events, transactions and other matters that have been recorded pertains to the entity (***Rights and Obligations)*** |
| 3. All transactions and events that should have been recorded have been recorded and no transaction and event is omitted ***(Completeness)***. | 3. All assets, liabilities and equity that should have been recorded have been recorded (***Completeness)*** | 3. All disclosures that should have been included in the financial statements have been included ***(Completeness)***. |

| | | |
|---|---|---|
| 4. Transactions and events have been recorded at appropriate amounts (*Accuracy)* | 4. Assets, liabilities and equity are included in the financial statements at appropriate amounts (*Valuation)* | 4. Financial and other information are disclosed at appropriate amounts *(Accuracy &Valuation)* |
| 5. Transactions and events have been recorded in the correct accounting period *(Cut-off)* | 5. Assets, liabilities and equity recorded in the financial statements have exist as at the period end. | |
| 6. Transactions and events have been recorded in the proper accounts *(Classification).* | | 5. Financial information is appropriately presented, described and disclosures are presented in a manner understandable to the users (*Classification).* |

# SECTION-II: AUDIT OF SHARE CAPITAL

## A. Audit Procedures

1. Period- end Share capital balance (Authorized, Issued and paid up) should be reconciled with the previous year audited financial statements.
2. In case there in no change in capital during the year, a written confirmation to be obtained from the Company.
3. In case there is any change in share capital, the following documents should be obtained:
    a. Certified copies of relevant resolutions passed at Board Meeting and Shareholders Meeting.
    b. Copies of Various forms filed with MCA (e.g., SH-7 and PAS-3)
    c. Copies of various forms filed with RBI, when shares are allotted to Non-residents (e.g., FCGPR)
4. Ensure that the paid-up share capital is within the limits of authorized capital.
5. Calculation and payment of stamp duty on increase of authorized capital should be verified.
6. In case the shares are issued at premium, then compliance with Sec.52 of Companies Act, 2013 shall be verified.
7. Auditor has to verify whether the company has issued any shares at discount. This can be done by reviewing the minutes of meetings of directors and shareholders.
8. If the company has issued any sweat equity shares, the auditor shall verify compliance with the provisions of Sec.54
9. Auditor needs to verify whether the fresh issue of shares was rights issue or preferential issue and whether the relevant requirements of CA, 2013 have been complied with.

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## B. Shares Issued at Premium (Sec.52)

1. <u>Transfer of Premium</u> - Where a company issues shares at a premium, whether for cash or otherwise, the amount shall be transferred to a "securities premium account"".
2. <u>Applicable provisions</u> – Provisions of CA, 2013 relating to reduction of share capital shall apply to such account as if it is a paid-up share capital of the Co.

3. Application of Securities Premium

| *Prescribed Class of Companies complying with Accounting Standards prescribed u/s 133* | *Other Companies* |
|---|---|
| a. For issuing fully-paid Bonus equity shares to the members of the Company. | i. For issuing fully-paid bonus shares to the members of the Company. |
| b. Writing off expenses incurred in issue of equity shares such as commission paid or discount allowed. | ii. Writing off expenses incurred in issue of shares or debentures, such as commission or discount allowed |
| c. Buy-back of shares U/s 68 | iii. Buy-back of shares U/s 68 |
| | iv. For payment of premium on redemption of preference shares or debentures. |
| | v. Writing off the preliminary expenses. |

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## C. Shares issued at Discount (Sec.53)

1. Prohibition

- A company shall not issue shares at a discount.
- Any shares issued by a Company at a discount price shall be void.

2. Exceptions

1. A Co can issue shares at a discount price u/s 54 i.e., issue of sweat equity shares.
2. A Co may issue shares at a discount to its creditors when their debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme framed in accordance with RBI regulations or the Banking Regulation Act.

3. Punishment for Default - Where a Co contravenes the provisions of this section:

a. The Company and every officer who is in default shall be liable to pay penalty up to:
⇒ The amount raised through the issue of shares at a discount; or
⇒ ₹ 5 lakhs, whichever is less
b. The company shall also be liable to refund all monies received with interest at the rate of 12% p.a. from the date of issue of such shares.

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## D. Issue of Sweat Equity Shares (Sec.54)

1. If the equity shares of the Co are listed on a recognized stock exchange, the sweat equity shares shall be issued in accordance with the regulations made by SEBI.

2. If the equity shares of the Co are not listed, then the sweat equity shares shall be issued in accordance with Rule-8 of Companies (Share Capital and Debentures) Rules, 2014.
3. Sweat equity shares must be of a class of shares already issued.
4. The issue of SES must be authorized by Special Resolution passed by the Company.
5. Such special resolution shall specify the number of shares, the current market price, Consideration and the classes of directors or employees to whom such equity shares are to be issued.
6. Rights, limitations and restrictions applicable to equity shares shall be applicable to Sweat Equity Shares.
7. Persons holding sweat equity shares shall rank pari-passu with other equity shareholders.

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## E. Reduction of Share Capital (Sec.66)

(i) Authorization in the Articles should be verified.

(ii) It has to be checked whether meeting was properly convened and special resolution was passed.

(iii) Order of the Tribunal confirming the reduction of share capital shall be verified.

(iv) Certificate issued by the registrar to be verified.

(v) Accounting entries recorded for reduction of capital and write-down of assets shall be vouched.

(vi) It has to be confirmed whether the revaluation of assets has been properly disclosed in the Balance sheet.

(vii) Confirm that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Verify whether the Memorandum of Association of the company has been suitably amended.

(ix) Check whether proper disclosures are made as required by Schedule-III.

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## F. Disclosure Requirements for share capital as per Schedule III to the CA, 2013

Following particulars shall be disclosed with respect to each class of equity shares

(a) The number and amount of shares Authorised;

(b) The number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) Par value per Share;

(d) Reconciliation of the number of shares outstanding at the beginning and at the end of the period;

(e) Rights, preferences and restrictions attaching to each class of shares;

(f) Shares held by its holding company, shares held by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) Shares held by each shareholder holding more than 5% shares specifying the number of shares held;

(h) Shares reserved for issue under options and contracts or commitments;

(i) For the period of five years immediately preceding the date at of Balance Sheet:

⇒ Aggregate number and class of shares allotted without payment being received in cash;
⇒ Aggregate number and class of shares allotted as bonus shares; and
⇒ Aggregate number and class of shares bought back;

(j) Terms of any securities convertible into equity shares issued along with the earliest date of conversion in descending order starting from the farthest such date;

(k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers);

(l) Forfeited shares (amount originally paid up).

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# SECTION-III: RESERVES AND SURPLUS

## A. Meaning and Categorization of Dividends

- Reserves are amounts appropriated out of profits.
- The reserves can be segregated as revenue or capital reserves.
- *Revenue reserves* represent profits that are available for:
  a. Distribution to shareholders.
  b. To finance the expansion of company's business.
  c. To build up the working capital.
  d. To strengthen the company's financial position.

- *Capital Reserves*

1. Capital reserves represent surplus or profit earned in respect certain transactions which are not the ordinary revenue generating activities of the enterprise. E.g., sale of fixed assets, re-issue of forfeited shares.

2. If a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.
3. Capital Reserves shall not be regarded as free for distribution.
4. Generally, Capital reserve can be utilized for writing down fictitious assets or losses or for issuing bonus shares if it is realized.
5. Securities premium Account or Capital Redemption Reserve Account can be utilized only for the purpose specified in Sections 52 and 55.

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## B. Audit Procedures

1. Opening balance of reserves and surplus to the cross-checked with the previous year audited financial statements.
2. Movement in Profit & Loss Balance shall be traced to the Statement of Profit or loss.
3. Adjustments related to dividend payments shall be verified with the resolution passed by the board of directors.
4. If dividends to equity shareholders are declared after the balance sheet date, liability should not be recognized as at the balance sheet date but appropriate disclosures shall be made.

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## C. Disclosure requirements for Reserves and Surplus as per Schedule III to the Companies Act, 2013

Reserves and Surplus shall be classified as follows:
(a) Capital Reserves;
(b) Capital Redemption Reserve;
(c) Securities Premium;
(d) Debenture Redemption Reserve;
(e) Revaluation Reserve;
(f) Share Options Outstanding Account;
(g) Other Reserves–(nature, purpose and amount);
(h) Surplus. It represents Balance in Statement of Profit and Loss and appropriations from it such as dividend, bonus shares and transfer to/ from reserves, etc.;

*(i) Under each of the above heads, additions and deductions since last balance sheet shall be shown*

*(ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus".*
*(iii) The balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.*
*(iv)A reserve specifically represented by earmarked investments shall be termed as a "fund."*

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# SECTION-IV: BORROWINGS

## A. Rights and Obligations

Following are the audit procedures required to be performed to ensure that all borrowings on the balance sheet represent valid claims by banks or other third parties.

1. Board minutes approving the new borrowings during the year to be reviewed.
2. Details of loan such as nature of loan, interest rate, and repayment terms as recorded in the books should be cross-checked with agreements.
3. Details of leases and hire-purchase balance should be checked with the concerned contracts
4. Independent balance confirmation to be obtained for all borrowings.

## B. Valuation

Following are the audit procedures required to be performed to ensure that liability in respect of borrowings is recorded at correct amount:

1. Determine that the accounting policies and methods of recording debt adopted by the entity are appropriate and determine whether such policies and methods are applied consistently.
2. Compare the loan balance to the loan agreement.
3. Recompute the interest and discount or premium on redemption.
4. Check computation of the amortization of premium or discount.
5. With respect to foreign currency loans, verify whether closing balances has been recomputed using the exchange rate prevailing at the end of the year.

## C. Presentation and Disclosures

1. If the entity fails to comply with any provisions of the borrowing agreements, determine whether the debt is classified as current.
2. If enforcement of the provisions has been waived by the lender obtain confirmation of the waiver from the lender.
3. Verify whether defaults with respect to restrictive covenants has been appropriately disclosed in the financial statements.
4. Examine the due dates for repayment of loans for determining whether proper classification has been made between long-term and short-term and short-term loans.
5. Ensure that instalments of long-term loans falling due within the next twelve months have been disclosed under current liabilities.
6. Verify whether the particulars of charges has been disclosed as per the statutory requirements and for proper understanding of the financial statements.
7. In case the value of the security falls below the amount of the loan outstanding, examine whether the loan is classified as secured only to the extent of the market value of the security.
8. Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.
9. Ensure that the disclosure requirements of Schedule-III of Companies Act, 2013 has been complied with.

## D. Direct Confirmation Procedures

1. Independent balance confirmations to be obtained in respect of all the borrowings.
2. Confirmation to be drafted incorporating all the information relevant to the audit (e.g., debt balance, interest balance, due dates etc.).
3. Reminders to be sent for non-replies.
4. Balance as reflected in the confirmations received to be compared with the balances as appearing in the books of accounts.
5. Reconciliations to be obtained in respect of any differences in confirmations and book balances.

## E. Disclosure requirements for Long-Term Borrowings as per Schedule-III to the Companies Act, 2013

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| *Classification* | Long-term borrowings shall be classified as:<br>(a) Bonds/debentures;<br>(b) Term loans:<br>(c) Deferred payment liabilities;<br>(d) Deposits;<br>(e) Loans and advances from related parties;<br>(f) Long term maturities of finance lease obligations;<br>(g) Other loans and advances (nature to be specified). |
| *Disclosure Requirements* | (a) Borrowings shall be further sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.<br>(b) Amount of loans guaranteed by directors or others under each head shall be disclosed.<br>(c) Bonds/debentures shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date.<br>(d) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.<br>(e) Terms of repayment of term loans and other loans shall be stated.<br>(f) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case. |

# SECTION-V: TRADE RECEIVABLES

<u>Considerable points</u>

System for trade receivables shall consist of the following features:

1. Only bona fide (genuine) sales reflect in trade receivables.
2. All such sales are made to approved customers.
3. All such sales are recorded.
4. Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.

5. Debtor Balances are regularly reviewed.
6. There is a proper system for follow up of debtors.
7. Debtors are collected on time.
8. Adequate provision is made for receivable not collectable.

## A. Procedure to examine Existence Assertion

Following procedures are required to be performed by the auditor to ensure that trade receivables as reflected in the financial statements exist as at the period- end:

1. It has to be examined whether the entity has established controls to ensure that invoices are not recorded more than once.
2. Debtors Aging report to be obtained and the balances as per aging report to be compared with the balance in general ledger.
3. If the amounts received from debtors are adjusted on account rather than on invoice wise, a confirmation should be obtained from debtors for such adjustment.

*Direct Confirmation Procedures*

1. Direct confirmations to be obtained for all significant account balances and for certain randomly picked small outstanding balances.
2. It is preferable to use the confirmation form without any balance mentioned and requesting the debtor to fill the balance outstanding as per his records.
3. Auditor should maintain strict control over dispatch of confirmation request letters.
4. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
5. Auditor should request the entity to reconcile the discrepancies between the balance confirmed by the debtor and the balance shown in entity's records.
6. Where no reply is received, the auditor should perform alternate procedures including:
   a. Verifying the receipts in the subsequent period.
   b. Conducting detailed analysis of outstanding balance, to ensuring that outstanding balance represents identifiable transactions and such transactions actually occurred.
7. It has to be ensured that amounts receivable other than due to sales or services are not included in the trade receivable list.
8. Trends in sales and receivables to be analyzed and if there are any unusual changes in treads, reasons for such changes should be enquired with management.

## B. Procedure to verify Completeness Assertion

Following are the audit procedures required to be performed to ensure that Trade receivable balances that were supposed to be recorded have been recognized in the financial statements:

1. For the invoices recorded during the last few days, it has to be checked whether goods have been dispatched and not lying with the company.
2. With respect to bill and hold cases, supporting documentation should be verified to determine whether a sale has actually taken place or not.
3. Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors.
4. Match the invoices with the shipping details to verify whether there are any invoices issued in the subsequent period for which goods has been dispatched during the current period and as such should have been included in the receivables of the current period.
5. Verify the sales returns in the subsequent period to ascertain whether company has shipped more than the goods ordered by customers.
6. Credit memos issued after the period end should be reviewed to verify whether they relate to transactions belonging to the period under audit..

## C. Procedures to examine Valuation Assertion

1. Procedure followed by the company to compute the allowance for doubtful debts should be reviewed.

The method used for computing the allowance should be consistent with the previous year and should be appropriate to the business environment in which the entity is operating.

2. Aging report of receivables to be obtained and reviewed.
3. List of debtors under litigation to be obtained and compare with previous year.
4. Analyze the debtors and identify which appears to be doubtful and inquire the management as to why provision is not made for such debts.
5. Check that write-offs of the receivable balances have been approved by an appropriate authority.
6. Re-statement of foreign currency receivables to be checked.

## D. Disclosure requirements with respect to trade receivables as per Schedule-III to the Companies Act, 2013

1. Trade receivables shall be sub-classified as:
   (a) Secured, considered good;
   (b) Unsecured, considered good;
   (c) Doubtful.
2. Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the date they are due for payment should be separately stated.
   The split between more than 6 months and less than 6 months should be done from the due date and not from invoice date.
3. Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
4. Debts due by directors or other officers of the company or by firms or private companies respectively in which any director is associated should be separately stated.

# SECTION-VI: CASH AND CASH EQUIVALENTS

## A. Verification of Cash Balances

1. The cash should be checked not only on the last day of the year, but also to be checked surprisingly sometime after the close of the year.
2. If there are more than one cash balances, (e.g., when there is a cashier, a petty cashier, a branch cashier), all of them should be checked simultaneously.
3. It has to be ensured that cashier is present while cash is being counted and the cashier should sign the statement containing details of cash balance.
4. Temporary advances paid to employees such as I.O.U's should be checked as to whether they are approved by an authorized official.
5. Month-wise receipts and payments to be analyzed and if there are any unusual variations in any month, explanation should be obtained from management.

## B. Verification of Bank-Reconciliation Statement (BRS)

1. For all bank accounts, BRS to be obtained as at the reporting period end.
2. BRS's should be signed by authorized personally so as to fix responsibility for errors.
3. Balance as per bank book as appearing in the BRS should be compared with the bank confirmation letter or in its absence bank statement.

4. With respect to all material items under the head “Cheques issued but not presented for payment” bank statements for subsequent periods should be obtained and verified whether they are cleared.

   All cheques whose its validity period (say 3 months) has been lapsed, should be reversed and should not appear in BRS.

5. With respect to all material items under the head “Cheques deposited but not cleared” deposit slips to be verified.

   ⇒ If any cheques are not cleared within reasonable time after deposit, an explanation to be obtained from management.

   ⇒ If the management explanation is not satisfactory to the auditor, the auditor should verify the revenue recognition related to such parties and examine whether such recognition is as per the company’s policy.

6. All items under the head “Charges debited by the bank but not accounted in books” should be adjusted in the books of account.

## C. Direct Confirmation Procedures

1. Confirmation to be sought by the auditor directly from the bank with respect to all types of bank accounts viz., current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts.
2. In case of any discrepancy between the balance as appearing in the books and the balance confirmed by the banker, explanation to be sought from the management and if required adjustments to be made.
3. Where confirmation is not received, the auditor should perform the additional testing procedures which may include:
   a. Comparing the balance in the ledger account with the bank statement.
   b. Asking the management to logon to the internet bank in the presence of the auditor and show the available balance.
   c. Sending the audit team member to the bank along with the entity’s personal to obtain balance confirmation.

## D. Disclosure requirements for cash and cash equivalents as per Schedule III to the Companies Act, 2013

1. Cash and cash equivalents shall be classified as:
   (a) Balances with banks;
   (b) Cheques, drafts on hand;
   (c) Cash on hand;
   (d) Others (nature to be specified).

2. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
3. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
4. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
5. Bank deposits with more than twelve months maturity shall be disclosed separately.

# SECTION-VII: INVENTORIES

Inventories are assets:

a. Held for sale in the ordinary course of business; or
b. In the process of production for such sale;
c. In the form of materials or supplies to be consumed in the production process or in the rendering of services.

As per AS 2 - Valuation of Inventories, inventory should be valued at lower of cost and net realisable value.

## A. Procedures to examine Existence Assertion

Auditor shall perform the following procedures to establish the existence of inventory as at the period-end:

1. When the entity uses periodic system, inventory counting should be undertaken at the end of the period.
   When the entity uses perpetual system, inventory counting may be undertaken at any interim dates.
2. Auditor should participate in the inventory counting by the entity's personnel.
3. Auditor should observe whether the employees are adhering to the inventory counting guidelines prescribed by the management.
4. Auditor should stay at all times and be cautious about empty boxes.
5. Auditor should ensure that following goods are excluded from inventory counting:
   a. Goods consigned to the third parties.
   b. Goods belonging to the third party and held by the entity.
   c. Damaged stock.
   d. Obsolete stock.
6. Auditor should ensure that inventory of the entity lying with third party has been included in the count.

7. Auditor should perform cut-off procedures by test checking the shipping documents as of the period end.
8. Auditor should ask the entity's personnel to sign all stock count sheets to avoid conflicts.
9. Auditor should ensure that all stock sheets are accounted.
10. Any significant differences between the physical stock and the stock as per the records shall be investigated.

## B. Procedures to examine Completeness Assertion

Following procedures shall be performed to ensure that:

- Only the inventories held by entity have been recorded in the financial statements;
- Inventories belong to third parties are not included;
- Inventories owned by the entity and lying with a third party are included.

1. Analytical procedures should be performed by comparing the:
   - ⇒ Inventory turnover ratio;
   - ⇒ Inventory to Total Assets ratio,

   With the industry averages, budgetary expectations and prior year figures.
2. Non-financial information related to inventory, such as weights and other measurements should be examined.
3. Cut-off tests should be performed by checking the shipping documents immediately before and after the end of period.
4. Arithmetical accuracy of inventory listings should be verified.
5. Physical inventory count shall be reconciled with general ledger control totals.

## C. Procedures to examine Rights and Obligations Assertion

1. Purchases recorded should be verified with underlying documentation such as purchase invoice and goods received report.
2. Sales and receivables records should be examined.
3. Consignment agreements shall be reviewed.
4. It has to be ascertained whether there are any collateral agreements.
5. With respect to inventory held by third parties, declaration should be obtained from the letter head of the third party signed by an authorized personnel of third party.

## D. Procedures to examine Valuation Assertion

Following audit procedures are required to be performed to ascertain whether the Inventories have been valued appropriately and as per generally accepted accounting policies and practices:

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|---|---|
| *Raw Materials* | 1. It has to be ascertained whether the inventory is properly valued at lower of Cost or Net Realizable Value.<br>2. It has to be ascertained whether all the items of cost has been properly included in the cost such as carriage inwards, non-refundable duties etc.<br>3. Purchase invoices has to be test checked to verify the cost.<br>4. Storage costs should be excluded unless storage is necessary prior to the next stage of production process.<br>5. If the standard costs are used, auditor has to ascertain the basis for arriving at the standard costs and the accounting treatment for variance between actual costs and standard costs.<br>6. Valuation of damaged and Obsolete stocks has to be verified.<br>7. It has to be ensured that materials are not written down below cost, if the finished products in which they will be incorporated are expected to be sold at or above cost. |
| *Work-in-Progress* | 1. Auditor has to understand the basic production process.<br>2. Auditor has to ascertain the stage of production of various inventory items.<br>3. Auditor has to verify whether all relevant items of cost are included in valuation of work-in-progress.<br>4. Basis of inclusion of overheads to be ascertained and compared with the available data.<br>5. If the work-in-progress value is arrived on estimation basis, the basis for such estimation has to be verified for its appropriateness.<br>6. It has to be ensured that abnormal wastage is not included in valuation. |
| *Finished Goods* | 1. It has to be ascertained whether the Finished Goods are properly valued at lower of Cost or Net Realizable Value.<br>2. Vendor price lists to be obtained to determine whether the costs has been appropriately recorded. |

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| | 3. It has to be ensured that costs of inventory has been computed correctly as per AS-2 i.e., Cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present condition and location.<br>4. In case of manufacturing entities, it has to be ensured that only Direct Material, Direct Labor and Direct Overheads are included.<br>5. Ensure that overheads are included based on normal costs excluding abnormal wastage.<br>6. Inventory ageing schedule to be obtained to identify slow-moving items.<br>7. Inventory turnover ratios to be computed. Lower ratio may reveal obsolete inventory. |

## E. Disclosure requirements under Schedule-III to the Companies Act, 2013

1. Inventories shall be classified as:
   (a) Raw materials;
   (b) Work-in-progress;
   (c) Finished goods;
   (d) Stock-in-trade (in respect of goods acquired for trading);
   (e) Stores and spares;
   (f) Loose tools
2. Goods-in-transit shall be disclosed under the relevant sub-head of inventories.
3. Mode of valuation shall be disclosed for each class of inventory.
4. As per AS-2, the accounting policies adopted in measuring inventories and the cost formula used shall be disclosed in the Financial Statements.

# SECTION-VII: TANGIBLE ASSETS

## A. Procedures to examine Existence Assertion

Following audit procedures to be performed to ensure that Property Plant and Equipment (PPE) as recorded in the books does exist as at the period end.

1. Auditor should ascertain the entity's practice for physical verification i.e., whether the physical verification is done by the entity's personnel or by outsourced to third party.
2. Auditor should obtain and examine the evidence relating to supervision of physical verification process.

3. Physical verification report to be obtained along with working sheets.
4. Work sheets should reflect the asset identification numbers for various items of PPE.
5. Auditor should ensure that fixed assets register has been updated.
6. Physical verification report should be reconciled with fixed assets register.
7. Auditor should ensure that discrepancies, if any, between physical verification report and asset register are properly accounted for in the books of accounts.
8. Approvals to be obtained from appropriate management authority for deleting, the items found shortage in verification, from the books of accounts.

## B. Procedures to examine Completeness and Rights & Obligations Assertions

Following audit procedures are required to be performed to ensure that PPE recorded in the financial statements includes all PPE owned and controlled by the entity although lying with a third party but does not include any PPE that belong to third parties:

1. Obtain the schedule of PPE and ensure that it contains opening balance, additions during the year, deletions during the year and closing balance.
2. Check the arithmetical accuracy of the schedule i.e., Opening Balance + Additions – Deletions = Closing Balance.
3. Verify the opening balances with the previous year audited financial statements.

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4. With respect to additions during the year perform the following procedures:
   a. Verify whether all the internal procedures for acquisition has been complied with such as inviting tenders from approved vendors.
   b. Verify the approval of acquisition by authorized personnel E.g., Director-Production, Director-Finance etc.
   c. Check the purchase invoices and installation certificates to ensure that asset is capitalized in the books only on or after the date mentioned in the installation certificate.
   d. Auditor should ensure that spare parts are recognized as PPE only if they satisfy the criteria specified for the definition of property, plant and equipment i.e., expected to be used for a period of more than 12 months.

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5. With respect to deletions during the year, the following procedures are required to be performed:
   a. Understand the reason and rationale for disposal of an asset e.g., asset becoming aged and replaced by new asset or change in production process.
   b. Verify the management approval for disposal of asset.
   c. Verify whether proper procedure has been followed for disposal of asset.
   d. Verify the accounting treatment for gains/losses resulting from disposal of assets.

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**Following audit procedures are to be performed to ensure that the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements:**

1. Auditor should examine whether purchase invoices for various items of PPE are made in the name of the entity.
2. For additions to land and building, the auditor should scrutinize the conveyance deed to verify whether the entity is the legal owner or not. If necessary, the auditor should take opinion from the legal experts in accordance with SA-620.
3. The auditor should verify the original title deeds for all immoveable properties held as at the balance sheet date.
4. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders.
5. In addition, the auditor should also verify the register of charges, available with the entity to identify the charges created on PPE.
6. The auditor should also verify the register of charges maintained by the Registrar of Companies or any other legal authority such as CERSAI (Central Registry of Securitization Asset Reconstruction and Security Interest)

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## C. Procedures to examine Valuation Assertion

- For proper valuation of an asset, depreciation should be charged.
- Depreciation reflects the decline in the utility of the asset due to usage, effluxion of time and obsolescence.
- Depreciation represents the necessary cost to be incurred to earn revenue.

- Charging depreciation is a must to ensure that profit and loss statement reflects true and fair profit for the period.

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Following are the audit procedures required to be performed to ensure that PPE has been valued appropriately and as per generally accepted accounting principles and practices:

1. It has to be ensured that depreciation is charged on all items of PPE.
2. Only specified items such as free hold land should be excluded from depreciation provision.
3. Auditor should examine whether the Depreciation method used by the entity is appropriate to the pattern in which the benefits from the asset are consumed by the entity.
4. Auditor should ensure that an impairment assessment has been done for various items of property, plant and Equipment as required by AS-28.
5. If the entity has adopted cost model as its accounting policy, an item of PPE should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
6. If the entity has adopted revaluation model as its accounting policy, an item of PPE should be carried at its fair value as on the date of revaluation less any subsequent accumulated depreciation and any subsequent accumulated impairment losses.
7. Auditor should ensure that accounting policy selected by the entity has been applied to an entire class of property, plant and equipment.

## D. Disclosure Requirements under Schedule-III to the Companies Act, 2013 relating to Tangible Assets

1. Property, Plant and Equipment shall be broadly grouped under the following categories:
   (i) Tangible Assets.
   (ii) Intangible Assets.
   (iii) Capital Work-in-Progress.
   (iv) Intangible Assets under Construction.

2. Tangible assets shall be Classified as:
   (a) Land;
   (b) Buildings;
   (c) Plant and Equipment;
   (d) Furniture and Fixtures;

(e) Vehicles;
(f) Office equipment;

3. Assets under lease shall be separately specified under each class of asset. Leased assets include assets given on operating lease and assets taken on finance lease.

4. A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period shall be given.

5. Such reconciliation shall show the additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals.

6. Assets written down on reduction of capital and Assets which are revalued up or down shall be disclosed for a period of 5 years from the date of write down or revaluation.